

**ARIZONA HEALTH CARE  
COST CONTAINMENT SYSTEM**

FINANCIAL STATEMENTS  
AND ADDITIONAL INFORMATION

Year Ended June 30, 2003

# **ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM**

## **FINANCIAL STATEMENTS AND ADDITIONAL INFORMATION**

Year Ended June 30, 2003

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## **MANAGEMENT'S DISCUSSION AND ANALYSIS**

## **MANAGEMENT'S DISCUSSION AND ANALYSIS**

Management of the Arizona Health Care Cost Containment System (AHCCCS) provides this *Management's Discussion and Analysis* for the benefit of the readers of the AHCCCS financial statements. This narrative overview and analysis of the financial activities of AHCCCS is for the fiscal year ended June 30, 2003. We encourage readers to consider this information in conjunction with the basic financial statements and related footnotes that follow this section.

### **Financial Highlights**

#### **Government-Wide:**

*Net Assets* - The assets of AHCCCS exceeded its liabilities at fiscal year ending June 30, 2003 by \$26.4 million (presented as "net assets"). Of this amount, \$22.7 million was reported as "unrestricted net assets". Unrestricted net assets represent the amount available to be used to meet AHCCCS' ongoing general obligations to members and creditors. The remaining net assets are comprised of the net amount invested in capital of \$3.7 million.

*Changes in Net Assets* - AHCCCS' total net assets decreased by \$66.4 million (a 71.6 percent decrease in total net assets). A key factor of the decrease is attributable to the continued growth in the volume of services and membership due to the voter-approved ballot initiative passed on November 7, 2000, to expand the Title XIX Medicaid program (Proposition 204) that is funded from both the tobacco tax and tobacco litigation settlement revenue sources. There was a 71.9 percent decrease (\$47.8 million) of the previous fiscal year carryforward from the Tobacco Tax and Health Care Fund - Medically Needy Account and 100 percent decrease (\$22.9 million) of the carryforward from the Budget Neutrality Compliance Fund as these balances were expended to supplement the expansion of membership and services due to the Proposition 204 program. The expenditures from these two carryforward funding sources were authorized by the Legislature as a one-time supplement of funding from the General Fund.

#### **Fund Level:**

*Governmental Funds - Fund Balances* - As of the close of fiscal year 2003, AHCCCS' governmental funds reported a combined ending fund balance of \$18.7 million, a decrease of \$68.2 million (a 78.5 percent decrease) in comparison with the prior year. As previously discussed, the fiscal year carryforward for the General Fund of \$22.9 million from the Budget Neutrality Compliance Fund was fully expended by legislative authorization. Also, \$34.374 million of the previous fiscal year carryforward of \$47.8 million from the Tobacco Tax and Health Care Fund – Medically Needy Account was used to provide current year medical services.

*Proprietary Fund - Fund Balance* - The proprietary fund reported net assets of \$2.7 million, an increase of \$0.6 million in comparison with the prior year.

### **Overview of the Financial Statements**

This discussion and analysis is intended to serve as an introduction to AHCCCS' basic financial statements, which are comprised of three components: 1) government-wide financial statements, 2) fund financial statements and 3) notes to the financial statements.

#### **Government-Wide Financial Statements**

The Government-Wide Financial Statements are designed to provide readers with a broad overview of AHCCCS' finances in a manner similar to a private-sector business. The Statement of Net Assets and the Statement of Activities are two financial statements that report information about AHCCCS, as a whole, and about its activities that should help answer this question: is AHCCCS, as a whole, better off or worse off financially as a result of this year's activities? These financial statements are prepared using the flow of economic resources measurement focus and the accrual basis of accounting. They take into

account all revenues and expenses connected with the fiscal year even if cash involved has not been received or paid.

The Statement of Net Assets presents information on all of *AHCCCS'* assets and liabilities, with the difference between the two reported as "net assets". Over time, increases or decreases in net assets, along with other financial information, serve as indicators as to whether *AHCCCS'* financial position is improving or deteriorating.

The Statement of Activities presents information showing how *AHCCCS'* net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying events giving rise to the change occur, regardless of the timing of related cash flows. Therefore, revenues and expenses are reported in this statement for some items that will result in cash flows in future fiscal periods (e.g. incurred but not reported fee-for-service and reinsurance claims and earned but unused vacation leave).

Both statements report two categories:

- **Governmental Activities** - The activities in this category are primarily supported by state appropriations and federal and county intergovernmental revenues. The governmental activities of *AHCCCS* are specific to programs concentrated on the health and welfare of the citizens of Arizona. Most of *AHCCCS'* activities are reported in this category.
- **Business-Type Activities** - This category is comprised of the Healthcare Group operations. Members/customers of Healthcare Group are charged a premium for the health care coverage provided. The state also subsidizes this program with an appropriation from the Tobacco Tax and Health Care Fund - Medically Needy Account.

The government-wide financial statements can be found on pages 13 and 14.

### **Fund Financial Statements**

A fund is a fiscal and accounting entity with a self-balancing set of accounts that *AHCCCS* uses to keep track of specific sources of funding and spending for specific activities or objectives. *AHCCCS*, like other state agencies, uses fund accounting to ensure and demonstrate compliance with legislative appropriation funding requirements. All of the funds of *AHCCCS* can be divided into two categories: governmental funds and the proprietary fund.

**Governmental funds** - Governmental funds are used to account for essentially the same functions reported as governmental activities in the government-wide financial statements. However, unlike the government-wide financial statements, the governmental funds financial statements focus on near-term inflows and outflows of spendable resources, as well as on balances of spendable resources available at the end of the fiscal year. Such information may be useful in evaluating a government's near-term financing requirements. This approach is known as using the flow of current financial resources measurement focus and the modified accrual basis of accounting. These financial statements provide a detailed short-term view of *AHCCCS'* finances that assists management in determining whether there will be adequate financial resources available to meet *AHCCCS'* current needs.

Because the focus of governmental funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for governmental funds with similar information presented for governmental activities in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the State of Arizona's near-term financial decisions. Both the governmental fund balance sheet and the governmental fund statement of revenues, expenditures, and changes in fund balances provide a reconciliation to facilitate this comparison between governmental funds and governmental activities. The basic governmental fund financial statements and related reconciliations can be found on pages 15 through 17 of this report.

AHCCCS reports three governmental funds categories. Information is presented separately in the governmental fund balance sheet and in the governmental fund statement of revenues, expenditures, and changes in fund balances for the General Fund, Tobacco Tax and Health Care Fund - Medically Needy Account and Other Governmental Funds.

The Legislature adopts an appropriated budget for AHCCCS for the acute care (includes separate appropriations for Acute Care Base and Proposition 204 populations) and long-term care programs and for program administration. The annual appropriation is made separately for both the state matching funds and federal financial participation funds from Social Security Act Titles XIX (Medicaid) and XXI (State Children's Health Insurance Program). A budgetary comparison statement has been provided for the General Fund and Tobacco Tax and Health Care Fund - Medically Needy Account to demonstrate compliance with the budget.

**Proprietary fund** - This fund is used to account for activities that charge customers for the services provided. Proprietary funds are prepared using the flow of economic resources measurement focus and the accrual basis of accounting; the same method used by private sector businesses. There is no reconciliation needed between the government-wide financial statements for business-type activities and the proprietary fund financial statements.

AHCCCS maintains one proprietary fund that is classified as an enterprise fund. Under this fund, AHCCCS provides health insurance coverage for qualifying business organizations including some state political subdivisions. The basic proprietary fund financial statements can be found on pages 20 through 22 of this report.

## Notes to the Financial Statements

The notes to the financial statements provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements. The notes to the financial statements can be found on pages 23 to 35.

## Government-Wide Financial Analysis

As noted earlier, net assets may serve over time as a useful indicator of a government agency's financial position.

### AHCCCS Net Assets (in thousands of dollars)

	Governmental Activities		Business-type Activities		Total	
	2003	2002	2003	2002	2003	2002
Current assets	\$ 375,016	\$ 400,422	\$ 9,461	\$ 5,956	\$ 384,477	\$ 406,378
Capital assets	3,709	4,977	7	13	3,716	4,990
Total assets	378,725	405,399	9,468	5,969	388,193	411,368
Current liabilities	355,096	314,831	6,719	3,774	361,815	318,605
Total liabilities	355,096	314,831	6,719	3,774	361,815	318,605
Net assets:						
Invested in capital assets, net of depreciation	3,709	4,977	7	13	3,716	4,990
Restricted	-	6,563	-	2,182	-	8,745
Unrestricted	19,920	79,028	2,742	-	22,662	79,028
Total net assets	\$ 23,629	\$ 90,568	\$ 2,749	\$ 2,195	\$ 26,378	\$ 92,763

In the case of AHCCCS, assets exceeded liabilities by \$26.4 million at June 30, 2003.

The largest portion of AHCCCS' unrestricted net assets (49.7 percent) reflects cash available at the close of the fiscal year. The Tobacco Tax and Health Care Fund - Medically Needy Account (Major Fund) accounts for 23.7 percent of the available cash balance and will be available to pay for expenditures in the next fiscal year for both the Proposition 204 and Acute care programs. The cash attributable to the Medically Needy Account was derived from a voter-approved (November 2002) cigarette/tobacco product tax increase. The remaining balance of unrestricted net assets (26 percent) may be used to meet AHCCCS' ongoing general obligations for its health programs.

**AHCCCS Changes in Net Assets**  
(in thousands of dollars)

	Governmental Activities		Business-type Activities		Total	
	2003	2002	2003	2002	2003	2002
<b>Revenues</b>						
Program revenues						
Charges for services	\$ 5,090	\$ 4,248	\$ 26,283	\$ 21,244	\$ 31,373	\$ 25,492
Other Operating Grants and Contributions	380,674	376,185	-	-	380,674	376,185
Federal Operating Grants	3,122,325	2,504,620	-	-	3,122,325	2,504,620
General revenues						
State appropriations	857,803	796,383	-	-	857,803	796,383
Tobacco tax	138,450	77,876	-	-	138,450	77,876
Unrestricted interest income	1,558	-	116	-	1,674	-
Total revenues	4,505,900	3,759,312	26,399	21,244	4,532,299	3,780,556
<b>Expenses</b>						
Health Services	4,543,192	3,827,820	31,790	24,273	4,574,982	3,852,093
Excess (deficiency) before transfers	(37,292)	(68,508)	(5,391)	(3,029)	(42,683)	(71,537)
Transfers	(29,647)	(27,761)	5,945	2,032	(23,702)	(25,729)
<b>Increase (decrease) in net assets</b>	(66,939)	(96,269)	554	(997)	(66,385)	(97,266)
Net assets - beginning	90,568	186,837	2,195	3,192	92,763	190,029
Net assets - ending	\$ 23,629	\$ 90,568	\$ 2,749	\$ 2,195	\$ 26,378	\$ 92,763

At June 30, 2003, AHCCCS reported positive balances in net assets for the agency as a whole, as well as for its separate governmental and business-type activities.

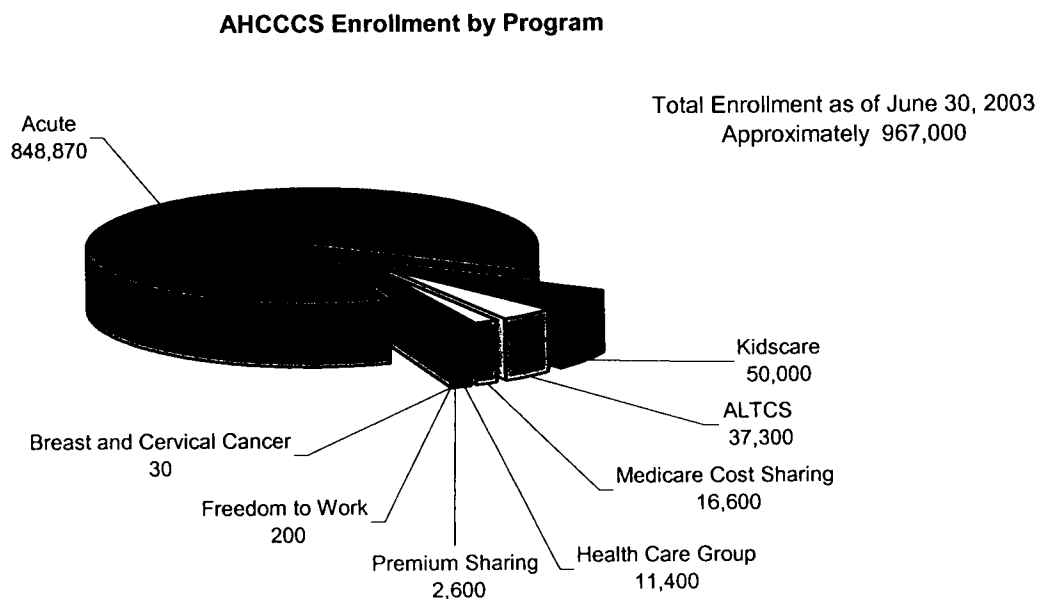
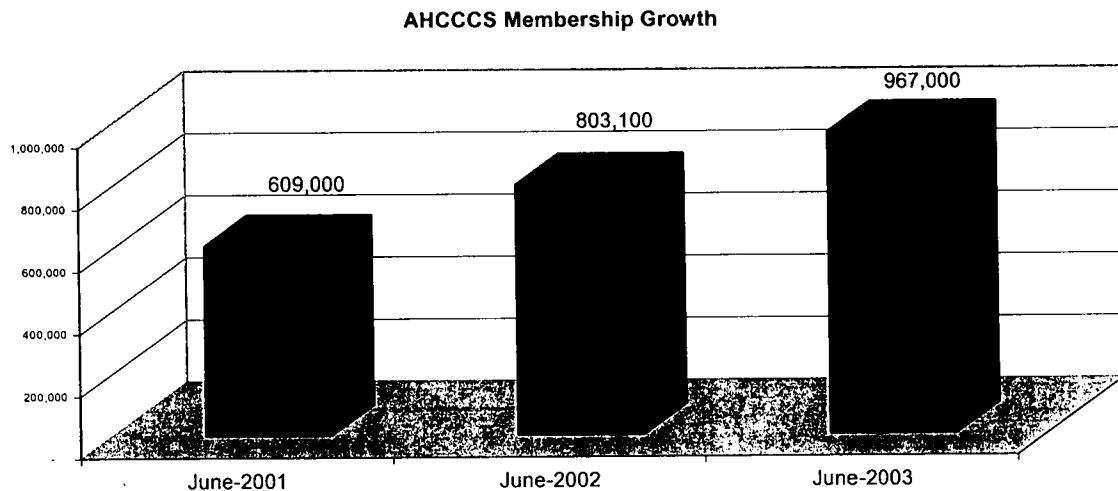
There was a \$554,000 increase in net assets reported in connection with AHCCCS' business-type activity. The increase resulted from an increase to the premium rate charged to participating employers effective February 1, 2003. A portion of the increase was intended to fully pay for marketing administrative costs that had previously been contracted out to the participating health plans. The actual administrative marketing costs were less than projected as only planning costs rather than implementation costs were incurred during the fiscal year. This resulted in a short-term savings in operating expenses and accounts for the increase in net assets. An aggressive marketing plan is being developed for the future that should eliminate future savings in this area. Additionally, the legislature approved a \$5.0 million appropriation reported as a transfer in on the statement of revenues, expenses, and changes in fund net assets – proprietary fund from the Tobacco Tax and Health Care Fund – Medically Needy Account to subsidize the Healthcare Group operating loss. Projected reinsurance expenses will expend the entire subsidy and have been accrued for on the statement of net assets – proprietary fund. The subsidy for fiscal year 2004 has been reduced to \$4.0 million.

As previously noted, AHCCCS' net assets decreased by \$66.4 million during the current fiscal year. The decrease is attributable to the increase in costs related to the continued enrollment growth due in part to Proposition 204, a voter-approved initiative. The initiative is funded from both tobacco tax and tobacco litigation settlement revenue sources. There was a 71.9 percent decrease (\$47.8 million) of the previous fiscal year carryforward from the Tobacco Tax and Health Care Fund - Medically Needy Account and a 100 percent decrease (\$22.9 million) of the carryforward from the Budget Neutrality Compliance Fund (General Fund). These sources were both expended to fund current year program activity as a one-time supplement to increase funding from the State's General Fund.

## Governmental Activities

Governmental activities decreased AHCCCS' net assets by \$66.9 million accounting for the entire decrease in the net assets of AHCCCS. Key elements of this decrease continue to be attributable to additional costs related to the unprecedented program enrollment growth. Since March 1, 2001, just prior to the implementation of Proposition 204, the overall program population has increased by 387,000 members to 967,000, a 67 percent growth rate. Of this amount, 111,900 (29 percent of the total 67 percent growth rate) are members who were made eligible by Proposition 204 since it became effective on March 1, 2001. From June 1, 2002 to June 1, 2003, the AHCCCS program population increased 163,900 (20 percent).

The following charts depict AHCCCS enrollment growth and enrollment by major eligibility category for the reporting period:



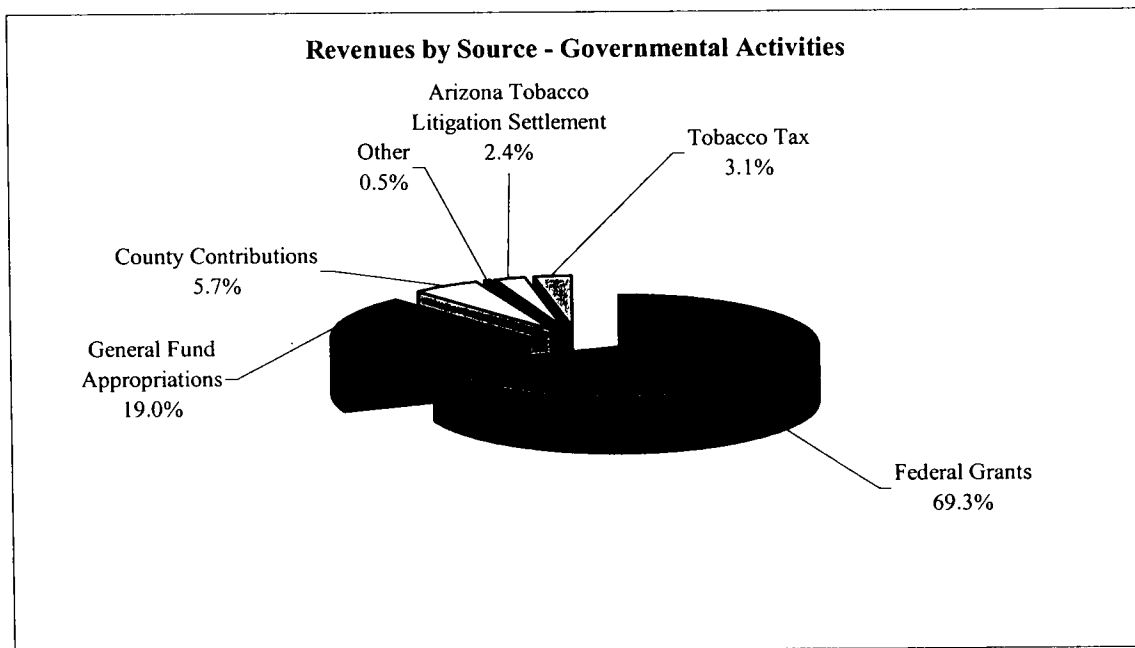
The cost of health care programs, including Title XIX Medicaid and Title XXI SCHIP, totaled \$4,543.2 million in fiscal 2003, a \$715.4 million increase over the \$3,827.8 million reported in fiscal year 2002. As shown in the Statement of Activities, the amount funded as federal grants through the Centers for

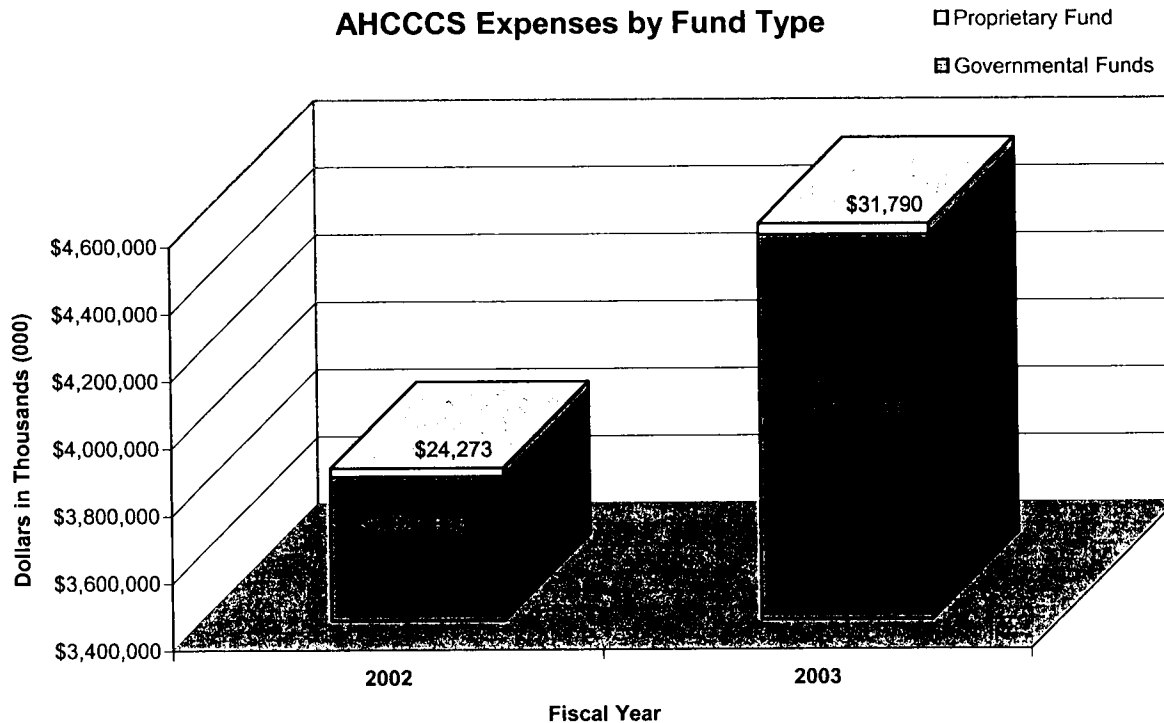


Medicare and Medicaid Services (CMS) was \$3,122.3 million (68.7 percent) in fiscal 2003. Funding in the form of federal financial participation is determined through the Federal Medical Assistance Percentages (FMAP) used to provide the amount of federal matching for State medical assistance expenditures. The FMAP or federal share of program costs is based on the relationship between Arizona's per capita personal income and the national average per capita personal income over three calendar years. The FMAP is recalculated each year and increased by 2.27 percent to 67.25 percent from the prior year's rate. In addition, the Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27) was signed into law on May 28, 2003. Subsection 401(a) provides temporary increases in the FMAP for all but certain expenditures. Under this provision, a 2.95 percent increase is available for five consecutive quarters beginning April 1, 2003.

State, county and miscellaneous funding sources combined to provide \$1,383.6 million in State funding sources and appropriations in fiscal 2003, a \$128.9 million increase over the \$1,254.7 million reported in fiscal year 2002. State General Fund revenues raised in the form of sales and income taxes directed to AHCCCS amounted to \$587.8 million and an additional \$270 million was passed through from other State agencies in order to provide the State's share for Title XIX Medicaid eligible medical assistance expenditures. Arizona counties contributed \$256.9 million as determined by Session Law. An additional \$109.5 million in State revenue funding was provided by the annual payments awarded to AHCCCS as administrator of the Tobacco Litigation Settlement Funds awarded to Arizona.

The following charts depict revenues of the governmental activities for the fiscal year and expenses for the reporting period:





### Business-Type Activities

The sole business-type activity for AHCCCS is the Healthcare Group (HCG). The HCG administers a prepaid medical coverage program for small businesses with 1 to 50 employees and employees of political subdivisions. HCG is intended to be self funded by charging a premium to participating employers that covers both the costs of providing medical services and administrative costs of the program. However, the program has been incurring operating losses for the past several years and has required a subsidy from the State to cover operating losses. The premium was increased effective February 1, 2003 to fully pay for medical services and administrative costs provided. As previously noted, the business-type activity increased AHCCCS' net assets by \$554,000. This increase is due primarily to a component of the premium rate increase discussed above that is intended to pay for marketing administrative costs that had previously been contracted out to the participating health plans. The actual administrative marketing costs were less than projected as only planning costs were incurred during this fiscal year. As in previous years, HCG was supported by a reinsurance subsidy from the Tobacco Tax and Health Care Fund – Medically Needy Account. The reinsurance subsidy for the current fiscal year was \$5 million, which is reflected as an Interfund Transfer in the Government-Wide Statement of Activities. The fiscal year 2004 subsidy has been reduced to \$4 million based upon an anticipated improvement in operations from the premium adjustment discussed above. Enrollment continued to decrease in fiscal 2003 (7.6 percent over the previous fiscal year). Management intends that the implementation of the marketing plan will reverse the declining enrollment trend.

### Financial Analysis of AHCCCS' Funds

#### Governmental Funds

At the end of fiscal year 2003, AHCCCS' governmental funds reported combined ending fund balances totaling \$18.652 million, a decrease of \$68.207 million in comparison with the prior year. As previously noted, the entire General Fund prior fiscal year carryforward of \$22.907 million from the Budget Neutrality Compliance Fund and \$34.374 million of the previous fiscal year carry forward of \$47.821 million from the

Tobacco Tax and Health Care Fund - Medically Needy Account were used to provide current year medical services.

The *general fund* is the chief operating fund of the AHCCCS Acute Care, Proposition 204 and Long-Term Care programs. The total fund balance of AHCCCS' general fund decreased by \$22.907 million this fiscal year. The carryforward was appropriated for funding the Proposition 204 program. The proposition 204 program utilizes revenue sources from the annual tobacco litigation settlement proceeds, tobacco products tax, and a State general fund appropriation.

The Tobacco Tax and Health Care Fund – Medically Needy Account is the only AHCCCS *major fund*. Its unrestricted fund balance is \$13.447 million at fiscal year-end and represents 72.1 percent of the total governmental fund's unrestricted fund balance. Revenues consist of a tax on cigarettes and other related tobacco products that generated \$93.993 million for the current year and accounts for 99.3 percent of the total Tobacco Tax and Health Care Fund – Medically Needy Account revenues. Interest earned on invested balances accounts for the remaining fund revenues.

The *other governmental funds* consist of six individual funds that have a combined total fund balance of \$5.205 million available to meet future year obligations. The ending fund balance decreased by \$10.926 million. Of this amount, the Children's Health Insurance Program Fund provided \$6 million during the current year to fund a portion of the general fund Acute Care Title XIX program supplemental appropriation by reducing the State match transfer amount required from the Tobacco Tax and Health Care Fund – Medically Needy Account to fund the KidsCare Program.

#### **General Fund Budgetary Highlights**

Significant differences occurred between the original and the final amended administrative and programmatic expenditure budgets (\$81.449 million) due to a combination of declining State revenues and the unprecedented growth in enrollment in the Title XIX Medicaid programs. The major revisions can be briefly summarized as follows:

- \$4.016 million decrease in administrative appropriations
- \$66.084 million increase to Proposition 204 – services
- \$36.346 million increase to the fee-for-service payments
- \$26.951 million decrease to capitation payments

Of this expenditure increase, \$68.209 million was reduced from the general fund and \$86.763 million was funded from increases in the Tobacco Tax contributions for the Acute Care and Proposition 204 programs. The remaining \$62.895 million represents increased federal expenditures funded by federal grant revenue. At year-end, actual cash basis expenditures were less than budgetary estimates, thus providing carryforward balances that are available to be used for administrative adjustments as authorized by State statute.

#### **Capital Asset Administration**

AHCCCS' investment in capital assets for its governmental and business type activities as of June 30, 2003 amounts to \$3.716 million, net of accumulated depreciation. This investment in capital assets includes furniture, vehicles and equipment. Land, buildings and improvements are under the management of the State of Arizona and are accounted for on the State's comprehensive annual financial report. Expenditures for capital assets during the year were significantly reduced as a result of the reductions to the administrative budget. In addition to the normal planned retirement of automated systems and related equipment and vehicles, thirty-two of the forty-six retired vehicles were the result of an efficiency review and needs assessment of the motor pool fleet in conjunction with the State budget cuts. The total decrease in AHCCCS' investment in capital assets for the current fiscal year was 25.5 percent.

**AHCCCS Capital Assets**  
(net of depreciation, in thousands of dollars)

	Governmental Activities		Business-type Activities		Total	
	2003	2002	2003	2002	2003	2002
Vehicles	\$ 918	\$ 1,465	\$ -	\$ -	\$ 918	\$ 1,465
Furniture and equipment	2,791	3,512	7	13	2,798	3,525
Total net assets	<u>\$ 3,709</u>	<u>\$ 4,977</u>	<u>\$ 7</u>	<u>\$ 13</u>	<u>\$ 3,716</u>	<u>\$ 4,990</u>

Additional information on AHCCCS' capital assets can be found in Note 2 in the accompanying financial statements on page 27.

**Long-Term Contingent Liability**

In January 2001, AHCCCS obtained a Section 1115 Waiver (Waiver) from the Centers for Medicare and Medicaid Services (CMS) to receive federal funding for certain non-categorically linked populations including those made eligible by the November 2000 passage of Proposition 204 by the citizens of Arizona. The Waiver requires that over the term of the agreement, April 1, 2001 through September 30, 2006, the population covered by the Waiver be budget neutral for CMS. Budget neutral means that CMS will not pay more for medical services with the Waiver than it would without it. The Waiver Special Terms and Conditions (STC) include a monitoring arrangement that requires AHCCCS to report the financial results of the Waiver on a quarterly basis. It also established a diminishing annual threshold of the amount that AHCCCS is able to exceed the Budget Neutrality limit on an interim basis before being required to submit a corrective action plan. The reporting limit threshold for the first budget neutrality period, which ended September 30, 2002, was 8 percent. At June 30, 2003 AHCCCS exceeded the limit for this period by \$48.2 million (2.09 percent) and was not required to submit a corrective action plan. The second budget neutrality period does not end until September 30, 2003, however, through June 30, 2003 the variance was positive.

If the current unprecedented enrollment growth continues, the projections indicate that AHCCCS will exceed the limit for the reporting period ending September 30, 2006. Although the STC state that, "If at the end of the 5½-year period of the budget neutrality agreement the limit has been exceeded, the excess federal funds will be returned to HCFA" (now CMS). However, it is important to point out that in conversations with consultants that have done extensive budget neutrality work with a number of different states, no example could be identified of a state actually having to return federal funds for a statewide 1115 Waiver. The normal course of affairs is that states have to modify existing waivers to reduce costs and, in some instances, the terms of the overall agreement have been modified. There is one instance where a county-based waiver may have had federal funds recouped, but it is uncertain as to whether this instance was driven by budget neutrality violations or program mismanagement. Also, calculation of the amount is dependent on many variables that have been volatile since the Waiver was granted. These include: estimating the number of new members due to Proposition 204, the economy and its impact on unemployment, medical inflation and policy decisions that impact program costs made by the Arizona Legislature. Accordingly, no loss contingency has been recorded in the AHCCCS financial statements for the amount that federal revenues exceeded the budget neutrality limit.

**Economic Factors and Next Year's Budgets and Rates**

- Since March 1, 2001 just prior to the implementation of Phase I of Proposition 204, the AHCCCS population has increased by 387,000 members to 967,000. This represents a 67 percent program enrollment growth through fiscal year-end. The primary forces contributing to the growth that occurred during this fiscal year are the newly eligible Proposition 204 population and the overall economic slowdown experienced in the State. While the rate of increase has slowed somewhat from the 46 percent increase experienced for the same period a year ago, the economic slowdown experienced in the State continues to impact the enrollment. Unemployment rates are a key indicator of enrollment. These rates have now somewhat stabilized. However, AHCCCS now covers approximately 17 percent of the Arizona population.

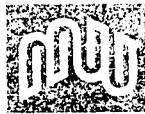
- Certain member categories are projected to incur strong growth. The *AHCCCS* Care Conversion capitated population now stands at 63,100 in June 2003. This population's growth rate exceed the 22.5 percent increase previously projected and is currently projected to grow by 23.9 percent from June 2003 to June 2004. This population remains the primary driving factor in higher costs. This population tends to incur more costs for services than most other categories as it includes individuals that were previously uninsured. Thus, capitation rates are higher and have a greater impact on the overall costs to the general fund.
- Inflationary trends for healthcare costs are incorporated in the rate development process for the managed care organization capitation rates. Historically, *AHCCCS* has been able to contain medical inflation well below national and state averages for commercial plans. However, due to substantial increases in utilization and costs for pharmacy, outpatient/ER and inpatient, the capitation rates were increased by an average of 13.08 percent for the current contract year period of October 2003 to September 2004. The inflation rate is indicative of medical inflation including the rising costs of pharmaceuticals. The key components in determining rate increases are: 1) medical inflation, 2) pharmacy costs 3) rising cost of new technology, 4) an aging population, and 5) newly eligible and woodwork populations that resulted from Proposition 204 which are assumed to have higher initial costs due to pent-up demand for medical services.

All of these factors were considered in preparing the *AHCCCS*' budget for fiscal year 2004. Although the possibility exists that *AHCCCS* will require a supplemental appropriation in fiscal year 2004, early fiscal year 2004 enrollment growth rate declines and the use of fiscal year 2003 reversion dollars makes it uncertain whether or not a supplemental appropriation will be necessary.

#### **Request for Information**

This financial report is designed to provide a general overview of *AHCCCS*' finances for the State's citizens, taxpayers and *AHCCCS*' members, providers and creditors. Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to the Arizona Health Care Cost Containment System, Division of Business and Finance, Attention: Finance Administrator MD 5400, 701 East Jefferson, Phoenix, Arizona 85034.

## **INDEPENDENT AUDITORS' REPORT**



## INDEPENDENT AUDITORS' REPORT

To the Director of the  
***Arizona Health Care Cost Containment System***

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the major fund, and the aggregate remaining fund information of

### ***ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM (AHCCCS, an agency of the state of Arizona)***

at and for the year ended June 30, 2003, as shown on pages 13 through 22. These financial statements and the schedule referred to below are the responsibility of **AHCCCS'** management. Our responsibility is to express an opinion on these financial statements and schedule based on our audit.

We conducted our audit in accordance with U.S. generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note 1, the financial statements of **AHCCCS** are intended to present the financial position, the changes in financial position and cash flows, where applicable, of only that portion of the governmental activities, the business-type activities, the major fund, and the aggregate remaining fund information of the state of Arizona that is attributable to the transactions of **AHCCCS**. They do not purport to, and do not, present fairly the financial position of the state of Arizona at June 30, 2003, and the changes in its financial position and its cash flows, where applicable, for the year then ended in conformity with U.S. generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the major fund, and the aggregate remaining fund information of **AHCCCS** at June 30, 2003, and the respective changes in financial position and cash flows, where applicable, thereof and the respective budgetary comparison for the general and major funds for the year then ended in conformity with U.S. generally accepted accounting principles.

The accompanying management's discussion and analysis on pages 1 through 10 and the budgetary comparison information on pages 18 and 19 are not a required part of the basic financial statements but are supplementary information required by the Governmental Accounting Standards Board (GASB). We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming an opinion on the financial statements that collectively comprise **AHCCCS'** basic financial statements. The accompanying Schedule of Expenditures of Federal Awards is presented for purposes of additional analysis as required by the U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and is not a required part of the basic financial statements. This schedule has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 14, 2003, on our consideration of **AHCCCS'** internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards*, and should be read in conjunction with this report in considering the results of our audit.

This report is intended solely for the information and use of **AHCCCS** and the state of Arizona Auditor General and is not intended to be and should not be used by anyone other than these specified parties.

*Miller Wagner & Company, PLLC*

November 14, 2003  
Phoenix, Arizona



## **BASIC FINANCIAL STATEMENTS**

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## STATEMENT OF NET ASSETS

June 30, 2003  
(amounts expressed in thousands)

<u>ASSETS</u>	Governmental Activities	Business-type Activities	Total
<b>CURRENT ASSETS</b>			
Cash	\$ 52,438	\$ 7,310	\$ 59,748
Restricted cash	11,232	3,332	14,564
Due from state and county governments	61,253	-	61,253
Due from the federal government	248,564	-	248,564
Internal balances	1,186	(1,186)	-
Receivables and other	343	5	348
<b>TOTAL CURRENT ASSETS</b>	<b>375,016</b>	<b>9,461</b>	<b>384,477</b>
<b>CAPITAL ASSETS</b>			
Furniture, vehicles and equipment, net of accumulated depreciation	3,709	7	3,716
<b>TOTAL ASSETS</b>	<b>378,725</b>	<b>9,468</b>	<b>388,193</b>
 <u>LIABILITIES</u>			
<b>CURRENT LIABILITIES</b>			
Accounts payable	22,169	13	22,182
Other accrued liabilities	1,967	14	1,981
Bank overdraft	3,954	-	3,954
Deferred revenue	17,012	3,878	20,890
Due to federal, state and county governments	55,588	-	55,588
Accrued programmatic costs	251,606	2,792	254,398
Compensated absences due within one year	2,800	22	2,822
<b>TOTAL CURRENT LIABILITIES</b>	<b>355,096</b>	<b>6,719</b>	<b>361,815</b>
 <b>COMMITMENTS AND CONTINGENCIES</b>			
 <u>NET ASSETS</u>			
<b>INVESTED IN CAPITAL ASSETS</b>	3,709	7	3,716
<b>UNRESTRICTED</b>	19,920	2,742	22,662
<b>TOTAL NET ASSETS</b>	<b>\$ 23,629</b>	<b>\$ 2,749</b>	<b>\$ 26,378</b>

See Accompanying Notes to Financial Statements

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## STATEMENT OF ACTIVITIES

Year Ended June 30, 2003  
(amounts expressed in thousands)

	Program Revenues				Net (Expense) Revenue and Changes in Net Assets		
	Program Expenses	Charges for Services	Federal Operating Grants	Other Operating Grants and Contributions	Governmental Activities	Business-type Activities	Total
<b>PROGRAMS</b>							
Government activities:							
Health care programs	\$ 4,543,192	\$ 5,090	\$ 3,122,325	\$ 380,674	\$ (1,035,103)	\$ -	\$ (1,035,103)
	<u>31,790</u>	<u>26,283</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>(5,507)</u>	<u>(5,507)</u>
Business-type activities:							
Healthcare Group	\$ 4,574,982	\$ 31,373	\$ 3,122,325	\$ 380,674	\$ (1,035,103)	\$ (5,507)	\$ (1,040,610)
<b>TOTAL PROGRAMS</b>							
General revenues:							
State appropriations					857,803	-	857,803
Tobacco tax					138,450	-	138,450
Unrestricted investment earnings					1,558	116	1,674
					<u>997,811</u>	<u>116</u>	<u>997,927</u>
Transfers:							
Transfers in					11,709	-	11,709
Transfers out					(35,411)	-	(35,411)
Interfund transfers					(5,945)	5,945	-
Total general revenues and transfers					<u>968,164</u>	<u>6,061</u>	<u>974,225</u>
CHANGE IN NET ASSETS					(66,939)	554	(66,385)
NET ASSETS, BEGINNING OF YEAR					90,568	2,195	92,763
NET ASSETS, END OF YEAR					\$ 23,629	\$ 2,749	\$ 26,378

See Accompanying Notes to Financial Statements

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## BALANCE SHEET - GOVERNMENTAL FUNDS

June 30, 2003  
(amounts expressed in thousands)

	General Fund	Tobacco Tax and Health Care Fund - Medically Needy Account	Other Governmental Funds	Total Governmental Funds
<b><u>ASSETS</u></b>				
Cash	\$ 37,616	\$ 5,376	\$ 9,446	\$ 52,438
Restricted cash	9,281	-	1,951	11,232
Due from state and county governments	12,508	6,885	1,899	21,292
Due from the federal government	94,655	-	153	94,808
Due from other funds	-	1,186	-	1,186
Receivables and other	319	-	24	343
<b>TOTAL ASSETS</b>	<b>\$ 154,379</b>	<b>\$ 13,447</b>	<b>\$ 13,473</b>	<b>\$ 181,299</b>
<b><u>LIABILITIES AND FUND BALANCES</u></b>				
Accounts payable	\$ 21,182	\$ -	\$ 987	\$ 22,169
Other accrued liabilities	1,967	-	-	1,967
Bank overdraft	3,954	-	-	3,954
Deferred revenue	15,061	-	1,951	17,012
Due to federal, state and county governments	54,956	-	632	55,588
Accrued programmatic costs	57,259	-	4,698	61,957
<b>TOTAL LIABILITIES</b>	<b>154,379</b>	<b>-</b>	<b>8,268</b>	<b>162,647</b>
<b>COMMITMENTS AND CONTINGENCIES</b>				
<b><u>FUND BALANCES</u></b>				
Unreserved	-	13,447	5,205	18,652
<b>TOTAL FUND BALANCES</b>	<b>-</b>	<b>13,447</b>	<b>5,205</b>	<b>18,652</b>
<b>TOTAL LIABILITIES AND FUND BALANCES</b>	<b>\$ 154,379</b>	<b>\$ 13,447</b>	<b>\$ 13,473</b>	

Amounts reported for governmental activities in the statement of net assets are different because:

Capital assets used in governmental activities are not financial resources and, therefore, are not reported in the funds.	3,709
Governmental funds report capital outlays as expenditures. However, in the statement of activities the cost of these assets is allocated over their estimated useful lives and reported as depreciation expense. AHCCCS, due to its pass-through nature, records revenue for all accrued expenditures. A receivable for revenue in the amount that depreciation (\$1,853) exceeded capital outlays (\$585) has been recorded in the current period.	1,268
Long-term liabilities for accrued paid time off are not due and payable in the current period and, therefore, are not reported in the funds.	(2,822)
Long-term receivables, offsetting the above accrued paid time off liability, which are not receivable in the current period and, therefore, are not reported in the funds.	2,822
IBNR variance between entire liability on the government-wide financial statements and fund financial statements.	(189,648)
Long-term receivables, offsetting the above IBNR liability which is not due and receivable in the current period and, therefore, are not reported in the funds.	189,648
<b>NET ASSETS OF GOVERNMENTAL ACTIVITIES</b>	<b>\$ 23,629</b>

See Accompanying Notes to Financial Statements

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCES - GOVERNMENTAL FUNDS

Year Ended June 30, 2003  
(amounts expressed in thousands)

	General Fund	Tobacco Tax and Health Care Fund - Medically Needy Account	Other Governmental Funds	Total Governmental Funds
<b>REVENUES</b>				
State government:				
Appropriations	\$ 548,495	\$ -	\$ 45	\$ 548,540
Pass through funds	270,044	-	-	270,044
Federal government:				
Acute care	1,731,847	-	59,163	1,791,010
Long-term care	458,993	-	-	458,993
Pass through funds	719,305	-	-	719,305
County government:				
Acute care	71,584	-	-	71,584
Long-term care	180,158	-	-	180,158
Pass through funds	5,118	-	-	5,118
Tobacco litigation settlement revenue	109,489	-	-	109,489
Tobacco tax revenue	30,116	93,993	14,341	138,450
Intergovernmental agreement revenue	-	-	8,542	8,542
Premium revenue	-	-	5,090	5,090
Other	4,661	626	2,054	7,341
<b>TOTAL REVENUES</b>	<b>4,129,810</b>	<b>94,619</b>	<b>89,235</b>	<b>4,313,664</b>
<b>PROGRAMMATIC EXPENDITURES</b>				
Capitation:				
Acute care	1,769,937	933	76,992	1,847,862
Long-term care	1,072,653	-	-	1,072,653
Children's rehabilitative services	35,897	-	2,288	38,185
Mental health services	479,083	-	9,861	488,944
Fee-for-service:				
Acute care	349,250	100	946	350,296
Long-term care	60,259	-	-	60,259
Disproportionate share	156,589	-	-	156,589
Graduate medical education	19,818	-	-	19,818
Reinsurance	40,805	-	490	41,295
Medicare premiums:				
Acute care	47,260	-	-	47,260
Long-term care	16,806	-	-	16,806
Payments to counties	4,861	-	-	4,861
<b>TOTAL PROGRAMMATIC EXPENDITURES</b>	<b>4,053,218</b>	<b>1,033</b>	<b>90,577</b>	<b>4,144,828</b>
<b>ADMINISTRATIVE EXPENDITURES</b>	<b>147,352</b>	<b>-</b>	<b>19,145</b>	<b>166,497</b>
<b>ADMINISTRATIVE EXPENDITURES PASSED THROUGH</b>	<b>40,899</b>	<b>-</b>	<b>-</b>	<b>40,899</b>
<b>TOTAL EXPENDITURES</b>	<b>4,241,469</b>	<b>1,033</b>	<b>109,722</b>	<b>4,352,224</b>
<b>EXCESS (DEFICIENCY) OF REVENUES OVER (UNDER) EXPENDITURES</b>	<b>(111,659)</b>	<b>93,586</b>	<b>(20,487)</b>	<b>(38,560)</b>
<b>OTHER FINANCING SOURCES (USES)</b>				
Transfers out:				
To AHCCCS General Fund	-	(74,841)	(12,320)	(87,161)
To AHCCCS Other Funds	-	(22,281)	-	(22,281)
To State General Fund	-	-	(400)	(400)
To Arizona Department of Health Services	-	(28,551)	-	(28,551)
To Health Crisis Fund	-	(869)	-	(869)
To Arizona Department of Economic Security	(5,118)	(473)	-	(5,591)
To Healthcare Group	-	(7,131)	-	(7,131)
Transfers in:				
From Tobacco Products Tax - Emergency Health Services Account	12,320	-	-	12,320
From Medically Needy	74,841	-	22,281	97,122
From State General Fund	6,109	-	-	6,109
From Arizona Department of Health Services Health Crisis Fund	600	-	-	600
From Healthcare Group	-	1,186	-	1,186
From Arizona Department of Health Services	-	5,000	-	5,000
<b>TOTAL OTHER FINANCING SOURCES (USES)</b>	<b>88,752</b>	<b>(127,960)</b>	<b>9,561</b>	<b>(29,647)</b>
<b>NET CHANGE IN FUND BALANCES</b>	<b>(22,907)</b>	<b>(34,374)</b>	<b>(10,926)</b>	<b>(68,207)</b>
<b>FUND BALANCES, BEGINNING OF YEAR</b>	<b>22,907</b>	<b>47,821</b>	<b>16,131</b>	<b>86,859</b>
<b>FUND BALANCES, END OF YEAR</b>	<b>\$ -</b>	<b>\$ 13,447</b>	<b>\$ 5,205</b>	<b>\$ 18,652</b>

See Accompanying Notes to Financial Statements

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## RECONCILIATION OF THE STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCES OF GOVERNMENTAL FUNDS TO THE STATEMENT OF ACTIVITIES

Year Ended June 30, 2003  
(amounts expressed in thousands)

Amounts reported for governmental activities in the statement of activities (page 16)  
are different because:

Net change in fund balance - total governmental funds (page 16)	\$ 68,207
Governmental funds report capital outlays as expenditures. However, in the statement of activities the cost of those assets is allocated over their estimated useful lives and reported as depreciation expense. This is the amount by which depreciation (\$1,853) exceeded capital outlays (\$585) in the current period.	<u>(1,268)</u>
Change in net assets of governmental activities (page 14)	<u>\$ 66,939</u>

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## BUDGETARY COMPARISON SCHEDULE - GENERAL FUND

Year Ended June 30, 2003  
(Unaudited)  
(amounts expressed in thousands)

	Original Appropriation (Budget)	Final Appropriation (Budget)	Actual	Variance with Final Budget
<b>REVENUES</b>				
State appropriations	\$ -	\$ -	\$ 609,896	\$ -
State pass-through funds	-	-	284,526	-
Federal government	-	-	2,305,474	-
Federal pass-through funds	-	-	628,650	-
County government	-	-	255,829	-
County pass-through funds	-	-	5,118	-
Tobacco tax revenue	-	-	26,223	-
Tobacco litigation settlement	-	-	109,489	-
Other	-	-	4,645	-
Total revenues	-	-	4,229,850	-
<b>OTHER FINANCING SOURCES</b>				
Operating transfers in	-	-	300,712	-
<b>TOTAL REVENUES AND OTHER FINANCING SOURCES</b>	-	-	4,530,562	-
<b>PROGRAMMATIC EXPENDITURES</b>				
Acute capitation	1,228,113	1,201,162	1,197,905	3,257
Acute fee-for-service	298,038	334,384	321,054	13,330
Proposition 204 services	649,672	715,756	711,060	4,696
Reinsurance	68,796	77,681	63,968	13,713
Medicare premiums	36,697	38,193	37,789	404
Graduate medical education	22,528	19,818	19,818	-
Disproportionate share	179,651	179,595	176,839	2,756
State emergency services	3,650	1,556	1,100	456
Breast and cervical cancer	2,275	1,875	945	930
Critical access hospitals	1,700	1,419	1,131	288
Freedom to work	1,346	1,001	373	628
County hold harmless	4,826	4,826	4,826	-
Long-term care	734,941	734,941	721,835	13,106
<b>TOTAL PROGRAMMATIC EXPENDITURES</b>	3,232,233	3,312,207	3,258,643	53,564
<b>ADMINISTRATIVE EXPENDITURES</b>	168,392	169,867	163,767	6,100
<b>OPERATING TRANSFERS OUT</b>	-	-	-	-
<b>TOTAL APPROPRIATED EXPENDITURES</b>	3,400,625	3,482,074	3,422,410	59,664
<b>NON-APPROPRIATED EXPENDITURES</b>	-	-	1,157,519	-
<b>REVENUES AND OTHER FINANCING SOURCES OVER (UNDER) EXPENDITURES</b>	-	-	(49,367)	-
<b>FUND BALANCES, BEGINNING OF YEAR</b>	-	-	74,331	-
<b>FUND BALANCES, END OF YEAR</b>	\$ -	\$ -	\$ 24,964	\$ -

See Accompanying Notes to Financial Statements

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## BUDGETARY COMPARISON SCHEDULE - TOBACCO TAX AND HEALTH CARE FUND - MEDICALLY NEEDY ACCOUNT

Year Ended June 30, 2003  
(Unaudited)  
(amounts expressed in thousands)

	Original Appropriation (Budget)	Final Appropriation (Budget)	Actual	Variance with Final Budget
<b>REVENUES</b>				
Tobacco tax revenue	\$ -	\$ -	\$ 91,912	\$ -
Other (primarily investment income)	-	-	626	-
<b>TOTAL REVENUES</b>	-	-	92,538	-
<b>OTHER FINANCING SOURCES</b>				
Operating transfers in	-	-	6,674	-
<b>TOTAL REVENUES AND OTHER FINANCING SOURCES</b>	-	-	99,212	-
<b>PROGRAMMATIC EXPENDITURES</b>				
Acute capitation	1,350	1,350	934	416
Acute fee-for-service	320	320	100	220
<b>TOTAL PROGRAMMATIC EXPENDITURES</b>	1,670	1,670	1,034	636
<b>ADMINISTRATIVE EXPENDITURES</b>	-	-	-	-
<b>OPERATING TRANSFERS OUT</b>	158,326	158,326	136,593	21,733
<b>TOTAL APPROPRIATED EXPENDITURES</b>	159,996	159,996	137,627	22,369
<b>REVENUES AND OTHER FINANCING SOURCES OVER (UNDER) EXPENDITURES</b>	-	-	(38,415)	-
<b>FUND BALANCES, BEGINNING OF YEAR</b>	-	-	43,791	-
<b>FUND BALANCES, END OF YEAR</b>	\$ -	\$ -	\$ 5,376	\$ -

See Accompanying Notes to Financial Statements



# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## STATEMENT OF NET ASSETS - PROPRIETARY FUND

June 30, 2003  
(amounts expressed in thousands)

### ASSETS

#### CURRENT ASSETS

Cash	\$ 7,310
Restricted cash	3,332
Receivables and other	<u>5</u>
TOTAL CURRENT ASSETS	10,647

#### CAPITAL ASSETS

Furniture, vehicles and equipment, net of accumulated depreciation	<u>7</u>
TOTAL ASSETS	<u>\$ 10,654</u>

### LIABILITIES

#### CURRENT LIABILITIES

Accounts payable	\$ 13
Other accrued liabilities	14
Deferred revenue	3,878
Due to other funds	1,186
Accrued programmatic costs	2,792
Compensated absences due within one year	<u>22</u>

TOTAL CURRENT LIABILITIES	<u>\$ 7,905</u>
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#### COMMITMENTS AND CONTINGENCIES

### NET ASSETS

INVESTED IN CAPITAL ASSETS	\$ 7
UNRESTRICTED	<u>2,742</u>
TOTAL NET ASSETS	<u>\$ 2,749</u>

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN FUND NET ASSETS - PROPRIETARY FUND

Year Ended June 30, 2003  
(amounts expressed in thousands)

OPERATING REVENUES	
Premium revenue	<u>\$ 26,283</u>
OPERATING EXPENSES	
Premiums paid to health plans	25,459
Reinsurance	5,133
Salaries and employee benefits	662
Professional and outside services	234
Other	296
Depreciation	<u>6</u>
TOTAL OPERATING EXPENSES	<u>31,790</u>
OPERATING LOSS	(5,507)
NONOPERATING REVENUE (primarily investment income)	<u>116</u>
LOSS BEFORE TRANSFERS	<u>(5,391)</u>
TRANSFERS IN (OUT)	
To Tobacco Tax and Health Care Fund - Medically Needy Account	(1,186)
From Tobacco Tax and Health Care Fund - Medically Needy Account	<u>7,131</u>
NET TRANSFERS IN (OUT)	<u>5,945</u>
CHANGE IN NET ASSETS	554
NET ASSETS, BEGINNING OF YEAR	<u>2,195</u>
NET ASSETS, END OF YEAR	<u>\$ 2,749</u>

See Accompanying Notes to Financial Statements

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## STATEMENT OF CASH FLOWS - PROPRIETARY FUND

Year Ended June 30, 2003  
(amounts expressed in thousands)

### CASH FLOWS FROM OPERATING ACTIVITIES

Receipts from customers	\$ 27,320
Payments to health plans	(28,655)
Payments to employees	(677)
Payments to suppliers	(544)
Net cash used in operating activities	<u>(2,556)</u>

### CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES

Operating subsidies from other funds	<u>6,036</u>
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### CASH FLOWS FROM INVESTING ACTIVITIES

Increase in restricted cash	(324)
Interest	<u>132</u>
Net cash used in investing activities	<u>(192)</u>

NET CHANGE IN CASH	3,288
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CASH, BEGINNING OF YEAR	<u>4,022</u>
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CASH, END OF YEAR	<u>\$ 7,310</u>
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### RECONCILIATION OF OPERATING LOSS TO NET CASH USED IN OPERATING ACTIVITIES

Operating loss	\$ (5,507)
Adjustment to reconcile operating loss to net cash used in operating activities:	
Depreciation	6
Changes in operating net assets and liabilities:	
Decrease in accounts payable and other accruals	(14)
Increase in deferred revenue	1,037
Increase in accrued programmatic costs	1,937
Decrease in accrued compensated absences	<u>(15)</u>
NET CASH USED IN OPERATING ACTIVITIES	<u>\$ (2,556)</u>

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2003  
(amounts expressed in thousands)

### (1) Summary of Significant Accounting Policies

#### A. Reporting Entity

The accounting policies of the **Arizona Health Care Cost Containment System** ("AHCCCS" or the "Agency") conform to the U.S. generally accepted accounting principles applicable to governmental units. The financial statements of AHCCCS, as a department of the state of Arizona ("State"), are not intended to represent the related financial statement information of the primary government. The following is a summary of the significant accounting policies.

AHCCCS was established by the Arizona Legislature in November 1981 to administer health care for the State's indigent population. AHCCCS is a State agency managed by an independent cabinet level administration created by the Arizona Legislature ("Legislature"), and it is funded by a combination of federal, state and county funds. The federal portion is funded through the Centers for Medicare and Medicaid Services ("CMS") of the U.S. Department of Health and Human Services under a Section 1115 waiver approved by CMS, which exempts the AHCCCS program from certain requirements of conventional Medicaid programs. This waiver has been renewed by CMS through September 30, 2006. AHCCCS receives quarterly federal grants from CMS (as matching funds) to cover a portion of the health care costs of the residents of the State, eligible for the State's Title XIX Medicaid and Title XXI, State Children's Health Insurance Program ("CHIP"). State appropriations and county funds are based on annual budgets as dictated by the Arizona Legislature and specified in Arizona Session Law.

AHCCCS provides acute and long-term health care coverage to eligible residents of Arizona. Eligible residents include those who qualify under Section 1931(b) of the Social Security Act, Supplemental Security Income (SSI), children who meet certain age requirements from families receiving food stamps, and children and pregnant women whose household income meets eligibility requirements, and uninsured women needing active treatment for breast and/or cervical cancer.

Under AHCCCS, health care coverage is provided substantially through a competitive bidding process with private and county-sponsored health plans bidding for the enrollment of AHCCCS eligibles by geographical service area. In addition, AHCCCS purchases health care services directly from providers.

Other AHCCCS lines of business include the Healthcare Group, which provides prepaid medical coverage primarily to small businesses, and the Premium Sharing Program, which provides coverage to individuals who meet certain income criteria and who are not covered through other health insurance programs. The activities of the Healthcare Group are included in the proprietary fund. See Notes 5 and 6 for more information on these programs.

#### B. Basis of Presentation

The basic financial statements include both agency-wide and fund financial statements. The agency-wide financial statements report information on the entire Agency, while the fund financial statements focus on major funds. Each presentation provides valuable information that can be analyzed and compared between years to enhance the usefulness of the information.

The agency-wide financial statements (i.e., the statement of net assets and the statement of changes in net assets) report information on the entire Agency. The effect of all significant interfund activity has been removed from these statements.

The statement of activities demonstrates the degree to which the governmental and business-type activities direct expenses are offset by program revenues. Direct expenses are those that are clearly identifiable with a specific function. Program revenues include appropriations, contributions and grants that are restricted for the operational or capital requirements of a particular function or segment.

Fund financial statements provide information about the Agency's funds. Separate financial statements are provided for the governmental and proprietary funds. The General Fund is the Agency's primary operating fund and it accounts for all financial resources except those required to be accounted for in another fund. AHCCCS has one major fund, the Tobacco Tax and Health Care Fund - Medically Needy

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2003  
(amounts expressed in thousands)

### B. Basis of Presentation (continued)

Account, and one business-type activity, Healthcare Group. All remaining governmental funds are aggregated and reported as non-major funds.

### C. Measurement Focus, Basis of Accounting and Financial Statement Presentation

The government-wide financial statements are reported using the economic resources measurement focus and the accrual basis of accounting, as are the proprietary fund statements. Revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of the related cash flows. Proprietary Fund revenues are recognized when they are earned and expenses are recognized when they are incurred. Member premiums are due by the first day of the month preceding the month of coverage. At June 30, 2003, the deferred revenue balance was comprised of premium payments received for the months of July and August 2003.

The governmental fund financial statements are reported using the current financial resources measurement focus and the modified accrual basis of accounting. Revenues are recognized as soon as they are both measurable and available. Revenues are considered to be available when they are collectible within the current period or soon enough thereafter to pay liabilities of the current period. For this purpose, AHCCCS considers revenue to be available if they are collected within 30 days of the end of the current fiscal year. Expenditures generally are recorded when a liability is incurred, as under accrual accounting. Accrued programmatic costs include estimates for incurred but not reported (IBNR) claims for a 30-day period following the end of the fiscal year. Actual results for accrued programmatic costs may differ from such estimates. These differences are recorded in the period in which they are identified. However, expenditures related to compensated absences, claims and judgments are recorded only when payment is due.

AHCCCS reports the following significant governmental funds:

- The general fund is AHCCCS' primary operating fund for the Title XIX Medicaid program.
- The Tobacco Tax and Health Care Fund - Medically Needy Account fund accounts for all financial resources from a dedicated tax funding source to support various health programs through legislative appropriations or allocations.
- Additionally, AHCCCS reports the following fund types:
  - The Healthcare Group fund, reported as a business-type activity, accounts for the activities of a prepaid medical coverage program primarily to small, uninsured businesses with 1 to 50 employees and employees of political subdivisions.
  - Special revenue funds, reported as other funds, account for various health and administrative programs.

*Encumbrances* - Purchase orders, contracts and other commitments for expenditures are encumbered in order to reserve that portion of the applicable appropriation. This practice is employed as an extension of formal budgetary control. Total encumbrances outstanding at June 30, 2003 were \$173,701.

### D. Cash and Investments

Substantially all of the cash and investments maintained by AHCCCS are held by the State of Arizona Office of the Treasurer (the Treasurer). The cash and investments are invested by the Treasurer with other State monies. Investment income is allocated to AHCCCS on a pro rata basis. Amounts held by the Treasurer are recorded at fair value and totaled \$74,267 at June 30, 2003.

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2003  
(amounts expressed in thousands)

### D. Cash and Investments (continued)

The State is statutorily limited (by ARS §35-312 and §35-313) to certain investment types. Additionally, State statutes require investments made to be in accordance with the "Prudent Person" rule. This rule imposes the responsibility of making investments with the judgment and care that persons of ordinary prudence would exercise in the management of their own affairs when considering both the probable safety of their capital and the probable income from that capital. The Treasurer issues a separately published Annual Financial Report that provides additional information relative to the Treasurer's total investing activities.

Cash in the General Fund has been internally restricted by AHCCCS in the amount of \$9,281 for the Inter-Agency Service Agreement Fund. Cash in the Other Funds is legally restricted in the amount of \$1,951 for the Hawaii Arizona PMMIS Alliance (HAPA) Fund, as described in Note 5, and is offset by an equal amount of deferred revenue at June 30, 2003. Cash in the Proprietary Fund is legislatively restricted in the amount of \$3,332 for the reinsurance activity of contracted health plans and is offset by accrued programmatic costs and due to other funds at June 30, 2003.

In accordance with the Federal Cash Management Improvement Act guidelines, AHCCCS may only request federal funds under specified funding techniques. These techniques require that AHCCCS draw down or request funds for any check issued in accordance with its historical average check-clearing pattern. The timing difference that occurs, due to drawing down funds after the issuance of checks, may result in bank overdrafts to AHCCCS at various times during the year. At June 30, 2003, a bank overdraft of \$3,954 existed which represents the excess of checks issued over federal funds that had been drawn.

### E. Capitation Payments

AHCCCS' contracted health plans receive fixed capitation payments, generally in advance, based on certain rates for each AHCCCS member enrolled with the plan. The plans are required to provide all covered health care services to their members, regardless of the cost of care. If there are funds remaining, the plan retains the funds as profit; if the costs are higher than the amount of revenue received, the plan absorbs the loss, except for those cases eligible for reinsurance payments.

Capitation is paid prospectively as well as for prior period coverage (PPC). The PPC period is from the first day of the month of application to the time of enrollment with a contracted health plan. The risk under PPC is shared by both the contracted health plans and AHCCCS for contract year ended September 30, 2002. AHCCCS reconciles the actual PPC medical costs to the PPC capitation paid during the year. The reconciliation limits the contractor's profits and losses to 2%. Except for Title XIX waiver members, effective October 1, 2002, the PPC rates have been adjusted and the reconciliation of PPC costs is no longer necessary.

Similar risk sharing is in place for medical costs incurred by contracted health plans for the Title XIX Waiver Group (TWG) members. AHCCCS reconciles the contractor's PPC and prospective medical cost expenses to PPC capitation, prospective capitation, hospitalized supplemental payments, delivery supplemental payments and HIV/AIDS supplemental payments paid to the contractor during the year. The reconciliation limits the contractor's losses to 2% and profits to 4%. Accrued programmatic costs include approximately \$16,582 at June 30, 2003 that represents estimated settlement payments due to contracted health plans for the TWG reconciliation. Actual results may differ from this estimate and such differences will be recorded in the period in which they are identified.

### F. Reinsurance Payments

AHCCCS provides a stop-loss reinsurance program for its contracted health plans for partial reimbursement, after a deductible is met, of covered inpatient facility medical services incurred for members with an acute medical condition. For long-term care members, the program includes a deductible, which varies based on the health plan's member enrollment and the eligibility category of their members. For acute care members, health plans choose their deductible level for all eligibility groups. AHCCCS reimburses the health plans based on a coinsurance amount for inpatient-covered services incurred above the deductible.

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2003  
(amounts expressed in thousands)

### F. Reinsurance Payments (continued)

The reinsurance program also includes a special catastrophic reinsurance program, which covers conditions such as certain brain injuries, certain blood related disorders or those conditions resulting in covered organ transplantation. There is no deductible for catastrophic reinsurance cases, and AHCCCS reimburses the health plans at a percentage of the health plans' paid amount, less the coinsurance amount, unless the costs are paid under a subcapitated arrangement. For non-transplant catastrophic reinsurance, AHCCCS pays 85% of the health plans' paid amount up to \$650 and 100% thereafter. For transplants, payment is limited to 85% of the AHCCCS contract amount for the transplant services rendered or 85% of the health plans' paid amount, whichever is lower.

### G. Fee-For-Service Payments

The AHCCCS program is responsible for the cost of providing medical services on a fee-for-service basis to three populations: persons enrolled in the Emergency Services Program (ESP), persons enrolled in a health plan for less than 30 days, and Native American members enrolled with Indian Health Services (IHS).

The ESP provides for emergency medical care to persons who are ineligible for full AHCCCS coverage due to their lack of United States citizenship or lawful alien status. Outpatient medical services for the ESP and for members enrolled in a health plan for less than 30 days are reimbursed at capped fee-for-service rates based on the category of service provided. Inpatient medical services for these populations are reimbursed based on the category of service provided. Inpatient medical services for these populations are reimbursed based upon an inpatient per-diem reimbursement rate system.

Medical services provided at an IHS facility or by a tribal-owned facility licensed by IHS are reimbursed at rates determined by the Office of Management and Budget (OMB). Off-reservation services are reimbursed based on the AHCCCS inpatient and outpatient fee-for-service rates.

### H. Incurred But Not Reported Expenditures

In the accompanying financial statements, the fee-for-service and reinsurance expenditures include claims paid, claims in process and pending, and the estimate made by management for incurred but not reported (IBNR) claims. These IBNR claims include charges by physicians, hospitals and other healthcare providers for services rendered to eligible members during the period for which claims have not yet been submitted.

The estimates for IBNR claims are developed using actuarial methods based upon historical data for payment patterns and other relevant factors. Such liabilities are necessarily based on assumptions and estimates, and while management believes the amount is adequate, the ultimate liability may be in excess of or less than the amount provided. The methods for making such estimates and for establishing the resulting liability are continually reviewed and adjustments are reflected in the period determined.

### I. Disproportionate Share Hospital Payments

During 2003, CMS and the Arizona Legislature authorized AHCCCS to make a disproportionate share payment to Arizona hospitals that had provided care to a disproportionate share (as defined) of the State's indigent population. Expenditures for disproportionate share totaled \$156,589 for the year ended June 30, 2003.

### J. Taxes

AHCCCS is an agency of the state of Arizona and is not subject to income taxes.

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2003  
(amounts expressed in thousands)

### K. Use of Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at June 30, 2003, and the reported amounts of revenues and expenditures during the fiscal year then ended. Due to the nature of estimates, actual results may differ.

### L. 100% Federal Poverty Level Expansion and CMS Waiver

On November 7, 2000, the Arizona voters approved ballot Proposition 204. One of its primary components directed AHCCCS to increase the minimum qualifying income eligibility level up to 100% of the Federal Poverty Level. The proposition also designated AHCCCS as the administrator of the tobacco litigation settlement funds awarded to the State for compensation of costs incurred in providing its citizens with health care and other services necessitated by the use of tobacco products.

AHCCCS obtained a waiver from CMS to receive federal funding for the newly eligible populations and to fund additional legislation passed during the 2001 State legislative session to implement Proposition 204. The CMS waiver requires that the newly covered population not previously categorically eligible for Medicaid be budget neutral for CMS. The waiver period for budget neutrality began April 1, 2001 and extends through federal fiscal year 2006 at which time any federal funds received by the State that exceed the negotiated budget neutrality limit must be returned to CMS. Because any future settlement amount is currently not determinable, no liability for any excess federal funds has been recorded in the accompanying financial statements. See Note 9.

AHCCCS has classified the Arizona Tobacco Litigation Settlement Fund, created by ballot Proposition 204, as part of its General Fund. These funds are restricted for use as specified in litigation settlement and/or legislation. Annual settlement payments (\$77,945 in fiscal 2003) are made in April. In addition to annual payments, the agreement requires that five one-time payments (\$31,544 in fiscal 2003) be made in January of each year. These payments are subject to several adjustments for such factors as cigarette production and annual sales volume that are not presently determinable. Therefore, an accrual was not recorded at June 30, 2003 for the remaining payments.

### (2) Capital Assets

Capital assets, which consist of furniture, vehicles and equipment, are reported in the governmental and business-type activity columns in the government-wide statement of net assets. Capital assets are defined as assets with an initial, individual cost of more than \$5 and an estimated useful life in excess of two years. Such assets are recorded at historical cost and are depreciated over their useful lives ranging from 2 to 10 years. The costs of normal maintenance and repairs that do not add to the value of the asset or materially extend assets lives are not capitalized. The assets retired in the amount of \$2,060 in the current fiscal year were fully depreciated. Net asset balances and current fiscal year activity are as follows:

Balance, June 30, 2002	\$ 4,990
Additions	585
Retirements	-
Depreciation	(1,859)
Balance, June 30, 2003	<u>\$ 3,716</u>



# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2003  
(amounts expressed in thousands)

### (3) Compensated Absences

It is the State's policy to permit employees to accumulate earned but unused vacation, compensatory and sick pay benefits. There is no liability recorded on AHCCCS' financial statements for sick leave as any amounts eligible for payment when employees separate from State service are the responsibility of the Arizona Department of Administration. Amounts recorded in the government-wide financial statements consist of employees' vested accrued vacation and accrued compensatory time benefits. Balances and current fiscal year activity are as follows:

Balance, June 30, 2002	\$ 2,785
Additions	3,183
Reductions	(3,146)
Balance, June 30, 2003	<u>\$ 2,822</u>

All compensated absences are due within one year.

### (4) Tobacco Tax and Health Care Fund – Medically Needy Account

The Arizona Department of Revenue allocates funding to AHCCCS' Major Fund, the Tobacco Tax and Health Care Fund – Medically Needy Account. The Tobacco Tax and Health Care Fund – Medically Needy Account provides funding for services provided through the Title XIX Medicaid and Title XXI KidsCare programs and other legislatively authorized health related services or programs. Revenue sources for the Tobacco Tax and Health Care Fund – Medically Needy Account include Tobacco Tax proceeds and investment income. At June 30, 2003, the Major Fund balance was \$13,447. Amounts earned, expended and transferred during the fiscal year ended June 30, 2003 were as follows:

	<u>Tobacco Tax and Health Care Fund - Medically Needy Account</u>
Fund balance, June 30, 2002	\$ 47,821
Tobacco tax	93,993
Interest earned	626
Expenditures	(1,033)
Transfers in (out):	
To General Fund	(74,841)
To Arizona Department of Health Services (ADHS)	(28,551)
To Other Funds	(22,281)
To Health Crisis Fund	(869)
To Arizona Department of Economic Security (ADES)	(473)
To Healthcare Group	(7,131)
From Healthcare Group	1,186
From Tobacco Tax and Health Care Fund–Health Education Account	5,000
Fund balance, June 30, 2003	<u>\$ 13,447</u>

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2003  
(amounts expressed in thousands)

### (5) Other Funds

At June 30, 2003, the other fund balance of \$5,205 was comprised of the following funds:

- Tobacco Products Tax Fund, Emergency Health Services Account (EHSA) – the proceeds of which shall be used solely for the reimbursement of the uncompensated care, primary care services and trauma centers' readiness costs.
- Premium Sharing Program Fund - the purpose of which is to provide a medical services coverage program for the uninsured funded from Tobacco Tax proceeds and premiums collected from participants.
- Third Party Liability Fund - which is comprised of monies recovered from first and third party payers under various AHCCCS recovery programs prior to the disbursement to the appropriate programs. These programs include casualty, special treatment trusts, estate and health insurance recoveries.
- KidsCare Fund – which is used to account for Arizona's Title XXI State Children's Health Insurance Program that provides comprehensive healthcare coverage to targeted low-income children up to the age of 19 and eligible parents.
- Miscellaneous Funds - which account for various grants and other monies received for specific purposes. This includes the Hawaii Arizona PMMIS Alliance (HAPA). HAPA represents AHCCCS' project with Hawaii whereby AHCCCS processes the claim for Hawaii's Medicaid program.

Other funds earned, expended and transferred during the fiscal year ended June 30, 2003 were as follows:

	Tobacco Tax Fund- EHSA	Premium Sharing Program Fund	Third Party Liability Fund	KidsCare Fund	Miscell- aneous Funds	Total
Fund balances, June 30, 2002	\$ -	\$ 8,304	\$ 802	\$ 6,033	\$ 992	\$ 16,131
Receipts	14,341	1,777	833	62,028	9,931	88,910
Interest earned	16	167	17	47	78	325
Expenditures	-	(19,446)	(960)	(79,501)	(9,815)	(109,722)
Transfers in (out):						
General Fund	(12,320)	-	-	-	(400)	(12,720)
Medically Needy Account	-	10,920	-	11,361	-	22,281
Fund balances, June 30, 2003	<u>\$ 2,037</u>	<u>\$ 1,722</u>	<u>\$ 692</u>	<u>\$ (32)</u>	<u>\$ 786</u>	<u>\$ 5,205</u>

### (6) Proprietary Fund

The Healthcare Group was established in 1988 by the state of Arizona to administer prepaid medical coverage primarily to small, uninsured businesses with 1 to 50 employees and employees of political subdivisions. Healthcare Group Administration (HCGA) contracts with two health plans from the existing network of AHCCCS health plans to enroll members and provide healthcare services. HCGA conducts premium billing, collections and fund disbursement and data analysis. HCGA is responsible for the regulatory oversight of the health plans.

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2003  
(amounts expressed in thousands)

### (6) Proprietary Fund (continued)

For State fiscal year 2003, the Arizona Legislature authorized an appropriation of up to \$5 million from the Tobacco Tax and Health Care Fund - Medically Needy Account for the Healthcare Group, to be allocated among Healthcare Group health plans based on the budget projections of the plans. This allocation is included in transfers in the accompanying statement of revenues, expenses and changes in fund net assets – proprietary fund. HCGA revised its premium rates effective February 1, 2003 to fully fund reinsurance payments to the participating health plans from premium collections. These new rates are intended to eliminate the reliance of future appropriations. Current legislation only provides the appropriated funding for Healthcare Group through fiscal year 2004.

### (7) Retirement Plan

AHCCCS employees are covered by a defined benefit retirement plan administered by the Arizona State Retirement System Board. Benefits are established by State statute and provide retirement and long-term disability benefits to AHCCCS employees. The retirement plan is funded by payroll deductions from eligible employees' gross wages and matching amounts contributed by AHCCCS. These amounts satisfy the statutory requirement that employees and AHCCCS contributions must cover the actuarially determined current service costs of the retirement plan, plus amortization over a 30-year period of the unfunded past service liability. Payroll deductions as a percentage of employee wages were 2.0% for retirement and .49% for long-term disability for 2003. The matching amount contributed to the retirement plan by AHCCCS was \$1,132 in 2003 and is included in administrative expenditures in the accompanying agency-wide and governmental financial statements.

Retirement benefit payments are obligations of the retirement plan and not AHCCCS. Actuarial and financial data on the retirement plan are available from the retirement plan's separately issued Comprehensive Annual Financial Report.

### (8) Budgetary Basis of Accounting

The financial statements of AHCCCS are prepared in conformity with U.S. generally accepted accounting principles (GAAP). AHCCCS, like all other state of Arizona agencies, prepares its annual budget on a basis which differs from the GAAP basis. The State's accounting system and Arizona Revised Statutes and policies provide for an additional accounting period (13<sup>th</sup> month) to make payments for goods or services received or incurred by the end of the fiscal year and subsequently invoiced during the 13<sup>th</sup> month. The statements report total budget basis expenditures to include both the fiscal year and the 13<sup>th</sup> month activity. The State does not have a legally adopted budget for revenues. The reported appropriated (budget) amount is the final fiscal year appropriation after any adjustments plus any prior fiscal year expenditures paid in the current fiscal year in accordance with the administrative adjustment procedures as authorized by Arizona Revised Statutes. AHCCCS' controlling statute for program administrative adjustment procedures varies from the statutory requirement of other State agencies. AHCCCS is permitted to pay for approved system covered medical services presented after the close of the fiscal year in which they were incurred with either remaining prior year or current year available monies. This provides the opportunity for program expenditures to equal the appropriation (budget) amount.

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2003  
(amounts expressed in thousands)

### (8) Budgetary Basis of Accounting (continued)

The following is a reconciliation of the GAAP basis statement of revenues, expenditures, and changes in fund balances – governmental funds to the budgetary comparison schedules for the year ended June 30, 2003:

	General Fund Actual	Tobacco Tax - Medically Needy Actual
Budgetary basis fund balance, June 30, 2003	\$ 24,964	\$ 5,376
Basis of accounting differences:		
Increases to fund balance:		
Due from State and county governments	12,508	6,885
Due from the federal government	94,655	-
Due from other funds	-	1,186
Receivables and other	319	-
Total increases	107,482	8,071
Decreases to fund balance:		
Deferred revenue	(15,061)	-
Due to federal, State and county governments	(54,956)	-
Accrued programmatic costs	(57,259)	-
Payables and other	(5,170)	-
Total decreases	(132,446)	-
Total GAAP basis fund balance	\$ -	\$ 13,447

Non-appropriated expenditures of \$1,157,519 in the general fund consist of federal pass-through payments to other agencies and Proposition 204 expansion program payments.

### (9) Contingencies

*Grant adjustment* - Amounts received from CMS are subject to audit and adjustments. At June 30, 2003, AHCCCS had claimed reimbursement from CMS on its Form CMS-64 of approximately \$71.8 million representing additional reimbursement AHCCCS believes it is due for health care services provided to Native Americans off the reservation. CMS disallowed this claim. AHCCCS appealed this decision and the Department of Health and Human Services' Department Appeals Board upheld the disallowance. As a result, AHCCCS has not drawn down these funds from CMS nor are they included in the accompanying financial statements. AHCCCS believes reimbursement of these funds is supported in law and intends to continue to pursue recovery of these funds through legal efforts.

*Litigation and investigations* - AHCCCS has been named as a defendant in a variety of litigation, all of which are being defended by legal counsel. It is the opinion of AHCCCS, upon consultation with legal counsel, that none of these claims are likely to have a material adverse effect on AHCCCS' financial statements. In addition, AHCCCS believes that the funding of any material adverse judgment, sanction or repayment obligation in excess of its appropriation would require a special appropriation by the State.

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2003  
(amounts expressed in thousands)

### (9) Contingencies (continued)

*Compliance with laws and regulations* - AHCCCS is subject to numerous laws, regulations and oversight by the federal government. These laws and regulations include, but are not necessarily limited to, matters such as government health care program participation requirements, reimbursement for member services and Medicaid fraud and abuse. Violations of these laws and regulations could result in expulsion from government health care programs, together with the imposition of significant financial sanctions. Management believes that AHCCCS is in compliance with fraud and abuse laws and regulations, as well as other applicable government laws and regulations. Compliance with such laws and regulations can be subject to future review and interpretation as well as regulatory actions unknown at this time.

*Budget neutrality agreement* – In January 2001, AHCCCS obtained a Section 1115 Waiver (Waiver) from CMS to receive federal funding for certain non-categorically linked populations including those made eligible by the November 2000 passage of Proposition 204. The Waiver requires that over the term of the agreement (April 1, 2001 through September 30, 2006), the population covered by the Waiver be budget neutral for CMS. Under budget neutrality, CMS will not pay more for medical services with the Waiver than it would without the Waiver. The Waiver Special Terms and Conditions (STC) include a monitoring arrangement that requires AHCCCS to report the financial results of the Waiver on a quarterly basis. It also established a diminishing annual threshold of the amount by which AHCCCS is able to exceed the budget neutrality limit on an interim basis before being required to submit a corrective action plan. The reporting limit threshold for the first budget neutrality period, which ended September 30, 2002, was 8%. At June 30, 2003, AHCCCS exceeded the budget neutrality limit for this period by \$48.2 million (2.09 percent), but was below the 8% threshold and thus was not required to submit a corrective action plan. The second budget neutrality period does not end until September 30, 2003. Through June 30, 2003, cumulative expenditures under the budget neutrality agreement do not exceed the budget neutrality limit. The budget neutrality calculation is depended on a number of variables including the number of new Proposition 204 members, the general economy and its impact on unemployment, medical inflation and policy decisions that may impact program costs made by the Arizona Legislature. Given the uncertainty surrounding these factors, AHCCCS is not presently able to determine if the budget neutrality limit will ultimately be exceeded or if it is exceeded that CMS will require repayment of the excess. Management believes that as of June 30, 2003, AHCCCS does not have any liability related to CMS for the budget neutrality agreement. Accordingly, the accompanying basic financial statements have not been adjusted for the impact of any liability AHCCCS may have related to the budget neutrality agreement for Proposition 204.

### (10) Interfund Receivables, Payables and Transfers

Interfund activity is defined as transactions between funds administered by AHCCCS. The composition of interfund balances as of June 30, 2003 is as follows:

<u>Receivable fund</u>	<u>Payable fund</u>	<u>Amount</u>
Tobacco Tax and Health Care Fund – Medically Needy Fund	Healthcare Group	<u>\$ 1,186</u>

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2003  
(amounts expressed in thousands)

**(10) Interfund Receivables, Payables and Transfers (continued)**

	Transfers in			
	General	Other	Healthcare Group	Total
Transfers out:				
Other fund	\$ 12,320	\$ -	\$ -	\$ 12,320
Tobacco Tax and Health Care Fund –				
Medically Needy Fund	74,841	22,281	-	97,122
Healthcare Group	-	-	5,945	5,945
	<u>\$ 87,161</u>	<u>\$ 22,281</u>	<u>\$ 5,945</u>	<u>\$ 115,387</u>

In the government-wide statement of activities, the interfund activity has been eliminated. The total net transfers out of \$23,702 reported on the statement of activities represents transfer activities to other State departments.

**(11) Transactions with Other State Agencies**

*Transactions with other State agencies - AHCCCS contracts for administrative and programmatic services from other State agencies. Charges for administrative services are based on the performing agency's actual cost. Charges for programmatic services are generally based on actuarially determined capitation rates. The following is a summary of contracted services provided.*

*Administrative services - The Arizona Department of Economic Security (ADES) charges AHCCCS to determine eligibility for certain Title XIX members. The Arizona Department of Administration charges AHCCCS for data center services, equipment costs and telephone line charges. The Arizona Department of Health Services (DHS) charges AHCCCS for licensure, preadmission screening and resident review services and administrative costs associated with the Breast and Cervical Cancer Treatment program. The Arizona Office of Administrative Hearings charges AHCCCS for administrative hearing services. The Arizona Board of Nursing charges AHCCCS for licensing services for nurse assistants. These expenditures are included in administrative expenditures in the accompanying statement of revenues, expenditures and changes in fund balances - governmental fund. The following is a summary of transactions with these State agencies for the services described above for the year ended June 30, 2003.*

	<u>Expenditures</u>
Arizona Department of Economic Security	\$ 36,081
Arizona Department of Administration	6,076
Arizona Department of Health Services	1,438
Arizona Office of Administrative Hearings	379
Arizona Board of Nursing	210
	<u>\$ 44,184</u>

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2003  
(amounts expressed in thousands)

### (11) Transactions with Other State Agencies (continued)

*Programmatic services* - Certain health care-related programmatic services are provided by other State agencies, which include ADES and ADHS. AHCCCS receives the State and federal funds for these services and transfers them to the appropriate agencies pursuant to the terms of intergovernmental agreements. The total amount of federal funds received by AHCCCS and passed through to these agencies was \$645,475 in 2003. The total amount of State funds received by AHCCCS and passed through to these agencies was \$270,028 in 2003. The amount passed through to ADES was \$297,554 of federal funds and \$152,049 of State funds in 2003 and is classified as long-term care capitation programmatic expenditures in the accompanying governmental funds statement of revenues, expenditures and changes in fund balances. The amount passed through to ADHS was \$347,921 of federal funds and \$117,979 of State funds in 2003 and is classified as capitation-mental health services and Children's Rehabilitative Services expenditures in the accompanying statement of revenues, expenditures and changes in fund balance - governmental funds.

Revenues include \$251,743 from Arizona counties during fiscal 2003. To the extent expenditures for long-term care services are less than county and State contributions, AHCCCS is required to remit such amounts equally to the State and the counties. At June 30, 2003, AHCCCS has accrued \$10,299, payable 50% to the State and 50% to the counties, relating to the amount that county and State contributions will exceed related expenditures. This amount is included in the due to federal, State and county governments in the accompanying balance sheet - governmental funds.

### (12) Other Pass Through Funds

Arizona school districts are eligible for federal matching funds for the administrative functions related to Early and Periodic Screening, Diagnosis and Treatment (EPSDT) outreach services at the school level. Arizona school districts are also eligible for federal matching funds on a fee-for-service basis for the provision of certain AHCCCS program services provided to eligible students. The total amount of federal funds received by AHCCCS and passed through to Arizona school districts was \$61,985 in 2003. This amount includes \$25,253 for administrative services, \$32,931 for program services, and \$3,801 for administrative costs associated with the payment of program services claims. These amounts are included within federal pass through funds in the accompanying statement of revenues, expenditures and changes in fund balances - governmental funds. Additionally, at June 30, 2003, AHCCCS accrued \$11,807 of unpaid claims for EPSDT outreach services.

Laws 2001, Chapter 344 enacted several changes to implement Proposition 204. Included is a requirement that the State Treasurer withhold funds in fiscal 2003 from the counties' transaction privilege tax revenues to offset administrative costs incurred by ADES for eligibility determination. The amount passed through to ADES in fiscal 2003 was \$5,118. Approximately \$38 was passed through to ADHS in connection with an agreement between ADHS and the U.S. Department of Health and Human Services. AHCCCS, through inter-agency agreements with ADES and ADHS, passed through \$645,475 in federal funds and \$270,028 in State funds for the provision of medical services.

At June 30, 2003, AHCCCS recorded total pass through revenue of \$994,467 and \$40,889 of administrative pass through expenditures in the accompanying statement of revenues, expenditures and changes in fund balance - governmental funds.

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2003  
(amounts expressed in thousands)

### (13) Subsequent Events

The State's General Fund revenue collections have been less than the budget expectations beginning in late fiscal year 2002 and that trend has continued through most of fiscal year 2003. This trend of declining revenue collections appears to have ended as actual fiscal year 2003 revenue collections were slightly above the final fiscal year budgeted amount. The economic downturn, which resulted in a significant decline in the State's revenue stream, appears to have ended. AHCCCS' management is currently unable to estimate the budgetary impact on its operations for fiscal year 2004 and beyond. However, AHCCCS initiated plans to reduce both the administrative and program budgets to the extent possible, and believes the Arizona Legislature may impose some additional level of budget cuts for fiscal 2004 and beyond. The accompanying basic financial statements have not been adjusted for any changes that might result from the outcome of this uncertainty.



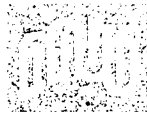
## **ADDITIONAL INFORMATION**

# ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

## SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

Year Ended June 30, 2003  
(amounts in Thousands)

<u>Federal Grantor/Pass Through Agency</u>	<u>Federal CFDA Number</u>	<u>Expenditures</u>
<b>U.S. Department of Health and Human Services</b>		
Centers for Medicare and Medicaid Services		
Medicaid Program (Title XIX)	93.779	
Federal funds expended to vendors		\$ 3,024,410
Federal funds expended to subrecipients		<u>37,060</u>
		3,061,470
 State Children's Health Insurance Program (Title XXI)	 93.767	 59,319
 Maternal and Child Health Bureau	 93.926B	
Healthy Start South Phoenix Project		10
 Health Resources and Services Administration	 93.256	
State Planning Grant - Health Care Access for the Uninsured		<u>231</u>
 TOTAL FEDERAL AWARDS EXPENDED		 <u>\$ 3,121,030</u>



REPORT ON COMPLIANCE AND ON INTERNAL CONTROL OVER FINANCIAL  
REPORTING BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN  
ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

To the Director of the  
**Arizona Health Care Cost Containment System**

We have audited the financial statements of the **Arizona Health Care Cost Containment System (AHCCCS, an agency of the state of Arizona)** at June 30, 2003 and for the year then ended, and have issued our report thereon dated November 14, 2003. We conducted our audit in accordance with U.S. generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.

**Compliance**

As part of obtaining reasonable assurance about whether the **Arizona Health Care Cost Containment System's** financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on the determination of the financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

**Internal Control Over Financial Reporting**

In planning and performing our audit, we considered the **Arizona Health Care Cost Containment System's** internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operations that we consider to be material weaknesses.

This report is intended solely for the information and use of the management of **Arizona Health Care Cost Containment System** and the state of Arizona Auditor General and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

*Miller Wagner & Company, PLLC*

November 14, 2003  
Phoenix, Arizona